

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:TEGE:EOEG:ET2

AGKelley

date: APR 7 2003

to: Walt MacDermitt N:CFO:I:PA

from: Lynne Camillo
Chief, CC:TEGE:EOEG:ET2

subject: **Travel Claim Belatedly Discovered Not Taxable**

This is in reply to your E-mail transmission dated February 27, 2003, in which you inquire about the procedure for correcting and reporting a travel reimbursement amount which was treated as taxable for income tax and employment tax purposes in a prior year (and consequently a withholding tax allowance was awarded to the employee), but such amount is determined in the subsequent year not to have been taxable for income tax and employment tax purposes.

For purposes of this discussion, a traveling employee was reimbursed \$100 for parking expense. The employee originally thought this reimbursement was taxable and filed a long-term taxable travel (LTTT) voucher. As a result of filing the voucher, the employee received in 2002 a withholding tax allowance (WTA), which was equal to the amount of the gross-up of the \$100 travel reimbursement necessary to make the employee whole with respect to the federal income tax withholding liability. (For purposes of this discussion, we will assume the WTA was \$37, based on the 27 percent flat rate of withholding income tax on supplemental wages.) In effect, the sum of the reimbursement plus the WTA equals the amount of wages (\$137) of the employee with respect to the reimbursement, and the withholding tax allowance is equal to the amount of income tax withholding (\$37) on that sum such that the employee can be paid the reimbursement net of federal income tax withholding. (However, because the gross up does not take into account FICA tax, the employee in practice receives less than the reimbursement amount in this situation.) The WTA and the reimbursement were reported on a Form 941, Employer's Quarterly Federal Tax Return, for a quarter of 2002 as wages. The income tax withheld was presumably also deposited and reported on the Form 941. In addition, Federal Insurance Contributions Act (FICA) tax (apparently the Medicare tax portion only, because the individual is covered under the Civil Service Retirement System) was withheld, reported, and paid on the Form 941. (For purposes of this example, we will use \$2 as the amount of withheld Medicare tax based on 1.45 percent of \$137.) Presumably, with respect to this travel reimbursement, the amount of 137 was entered in both Box 1 (Wages, tips, other compensation) of the

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employee's 2002 Form W-2, Wage and Tax Statement, and Box 5 (Medicare wages and tips) equal to the sum of the WTA and the travel reimbursement. In Box 2 (federal income tax withheld) the amount of the WTA (37) should have been entered. In Box 6 (Medicare tax withheld), the amount (2) of the employee portion of the Medicare tax withheld on the sum of the WTA and the travel reimbursement should have been entered.

In the next year (on February 27, 2003), the employee realized that the particular travel reimbursement was not includible in gross income or wages for FICA and income tax withholding purposes. Accordingly, he notified the payroll office to have his voucher recharacterized as regular travel (nontaxable) and to get a Form W-2c, Corrected Wage and Tax Statement.

The general procedures for the correction of overpayments of income tax withholding and FICA taxes are found in the Employment Tax Regulations. With respect to the repayment by the employer of tax erroneously collected from the employee after the employer has filed the Form 941 reporting the income tax withholding, section 31.6413(a)-1(b)(2)(i) of the regulations provides that if, in any calendar year, an employer collects from any employee more than the correct amount of tax under section 3402, and the employer pays the amount of such overcollection to the district director, the employer may repay or reimburse the employee in the amount thereof in any subsequent return period in such calendar year.

Section 31.6413(a)-1(b)(2)(ii) of the regulations provides that if the amount of the overcollection is repaid to the employee, the employer shall obtain and keep as part of his records the written receipt of the employee, showing the date and amount of the repayment. If the employer does not repay the amount of amount of the overcollection, the employer may reimburse the employee by applying the amount of the overcollection against the tax under section 3402 which otherwise would be required to be withheld from wages paid by the employer to the employee in the calendar year in which the overcollection was made.

Section 31.6413(a)-2(b) of the regulations provides that if, pursuant to section 31.6413(a)-1(b)(2), an employer repays or reimburses an employee in the amount of an overcollection of tax under section 3402, the employer may adjust the overcollection, without interest, by entering the amount thereof as a deduction on a return of tax under section 3402, filed by the employer for any return period in the calendar year in which the employer repays or reimburses the employee.

Section 31.6205-1(c)(4) provides generally that if no income tax, or less than the correct amount of income tax is withheld from wages paid by an employer to an employee, the employer shall collect the amount of the undercollection on or before the last day of such year by deducting such amount from remuneration of the employee, if any, under his control.

The effect of these regulations with respect to adjustments of income tax withholding is reflected in the administrative practice and publications of the IRS. Publication 15, Circular E, Employer's Tax Guide, provides as follows with regard to corrections of income tax withholding on Form 941c, Supporting Statement To Correct Information:

Note: *You may make an adjustment to correct income tax withholding errors only for quarters during the **same calendar year**. This is because the employee uses the amount shown on Form W-2 as a credit when filing the income tax return (Form 1040, etc.).*

You cannot adjust amounts reported as income tax withheld in a prior calendar year unless it is to correct an **administrative error**. An administrative error occurs if the amount you entered on Form 941 is not the amount you actually withheld. For example, if the total income tax actually withheld was incorrectly reported on Form 941 due to a mathematical or transposition error, this would be an administrative error. The administrative error adjustment corrects the amount reported on Form 941 to agree with the amount actually withheld from employees.

Although these rules apply generally to adjustments of overpayments and mirror rules related to the adjustment of overpayments, there are exceptions to the general rule that income tax withheld in one year cannot be credited in another year. There are special rules with respect to withholding on noncash fringe benefits. See Announcement 85-113, 1985-31 I.R.B. 31. The employer is allowed to make an estimate of the value of the fringe benefit provided to the employee at the end of the year. The actual value of the fringe benefits provided during a calendar year (or other period if the special accounting rule related to November and December is used) must be determined by January 31 of the following year (the date Form W-2 must be furnished to the employee), and the employer must report the actual value on Form W-2 and the Form 941 for the fourth quarter and pay any additional tax liability.

If the employer underestimates the value of the fringe benefits and thereby withholds less than the required amount of taxes from the employee, then the employer may recover from the employee the FICA or railroad taxes and, section 31.6205-1(c)(4) notwithstanding, the income taxes paid on the employee's behalf. The recovery of income taxes must occur prior to April 1 of the following year.

There are special rules relating to accountable plans. Amounts paid under an accountable plan are not includible in gross income and are not wages for federal income tax withholding and FICA purposes. To be an accountable plan, a reimbursement or allowance arrangement must meet all three of the following rules:

(1) The employees of the employer must have paid or incurred deductible expenses while performing services as employees.

(2) The employees must adequately account to the employer for those expenses within a reasonable period of time.

(3) The employees must return any amounts in excess of expenses within a reasonable period of time.

A reasonable period of time depends on the facts and circumstances. Generally, it is considered reasonable if employees receive the advance within 30 days of the time they incur the expense, adequately account for the expenses within 60 days after the expenses were paid or incurred, and they return any amounts in excess of expenses within 120 days after the expense was paid or incurred. Also, it is considered reasonable if the employer gives its employees a periodic statement (at least quarterly) that asks them to either return or adequately account for outstanding amounts and they do so within 120 days.

However, we are unaware of anything in the accountable plan regulations or rules that would allow a withholding tax allowance repaid in a subsequent year to change the amount of wages, tips, other compensation in Box 1 of Form W-2.

Although adjustments of income tax withholding for a prior year are prohibited except in the case of administrative errors, there is a provision allowing for employer's refund of income tax withholding in situations in which the income tax withholding was not deducted or withheld from an employee. Section 31.6414-1(a) of the Employment Tax Regulations provides that any employer who pays to the district director more than the correct amount of –

- (1) Tax under section 3402 or a corresponding provision of prior law, or
- (2) Interest, addition to the tax, additional amount, or penalty with respect to such tax,

may file a claim for refund of the overpayment or may claim credit for such overpayment, in the manner and subject to the conditions stated in this section and section 301.6402-2 of this chapter (Regulations on Procedure and Administration). If credit is claimed pursuant to this regulations section, the amount thereof shall be claimed by entering such amount as a deduction or a return of tax under section 3402 filed by the employer. If credit is taken pursuant to this regulations section, a claim on Form 843 is not required, but the return on which the credit is claimed shall have attached as a part thereof a statement, which shall constitute the claim for credit, setting forth in detail the grounds and facts relied upon in support of the credit, and showing such other information as is required by the regulations in this subpart and by the instructions relating to the return. No refund or credit to this employer shall be allowed under this section for the amount of any overpayment of tax which the employer deducted or withheld from an employee.

The question is raised whether section 31.6414-1(a) of the regulations applies to this situation. We believe that it does not apply. This provision was designed to apply to situations where the employer makes a payment of income tax withholding liability after the

year in which the remuneration was paid (for example, in response to an IRS audit) and later believes that the remuneration is not subject to income tax withholding. It is designed to apply to a situation in which the employee was not credited with income tax withholding on the employee's Form W-2, rather than a situation in which the employer is grossing up wage payments as they are made. The amount of income tax withholding in this case was in fact withheld from the grossed up payment to the employee and was reported as income tax withholding on the employee's Form W-2. Therefore, we conclude that the refund or credit procedure provided by section 31.6414-1(a) does not apply in this case.

We have given careful consideration to the information submitted. Although this may not be the best result from an administrative standpoint, this situation appears to fall within two general rules: (1) with respect to the withholding tax allowance paid on the employee's behalf in 2002, the general rule regarding the income tax treatment of erroneous overpayments of salary (i.e., such overpayments of salary are reported in Box 1 (wages, tips, other compensation) of Form W-2 for the year received unless repaid prior to the end of the calendar year); (2) with respect to the income tax withholding on the employee's behalf, the general rule prohibiting corrections of income tax withholding after the end of the calendar year. Thus, the overpayment of salary (in this case the withholding tax allowance) is included in income and wages if not repaid by the employee by the end of the year. Also there is no provision of the accountable plan rules that would allow correction of the error related to the withholding tax allowance after the end of the calendar year.

Therefore, with respect to the facts discussed at the beginning of this memorandum and assuming the employee is correct about the benefit not being included in income and wages, we believe a Form W-2c should be issued reflecting the amount of the withholding tax allowance in Box 1 of the Form W-2c, and the amount of the WTA, which is also the amount of income tax withholding with respect to the benefit, should also be reflected in Box 2 as withholding. The excludable parking benefit should be omitted from Box 1 of the Form W-2c. Box 5, Medicare wages and tips should also include the WTA, unless the WTA is repaid prior to the issuance of the Form W-2c. For Medicare wages, the repayment of the wages at any time within the statute of limitations would result in a reduction in Box 5. After the WTA is repaid to the Government, the amount in Box 5 of the Form W-2c should be reduced. You may want to request that the employee repay the amount of the withholding tax allowance before issuance of the Form W-2c, to avoid having to issue two Forms W-2c.

Applying the numbers used in the facts paragraph, the Form W-2c would be amended as follows with respect to the benefit and the WTA:

	<u>Original Form W-2</u>	<u>Form W-2c</u>
Box 1	137	37
Box 2	37	37
Box 5	137	37 (if WTA not repaid) 0 (if repaid)
Box 6	2	.55 (if WTA not repaid) 0 (if repaid).

If you have any questions about this, please contact Al Kelley.